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From One Pocket to the Other: The Abuse of Real Estate Investment Trusts Deductions

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From One Pocket to the Other: The Abuse of Real Estate Investment Trusts Deductions

I. INTRODUCTION

Many large, multi-state retailers and banks have been acting as their own landlord by paying rent to themselves. Sophisticated corporate tax strategists have employed a method of avoiding state taxes by using a real estate investment trust (REIT) to “own” its real estate. The retailer or bank then pays rent to the REIT, which then turns the money over to a holding company. The rent money ends up back in the hands of the corporate parent, without being subject to state income tax along the way.

Although this tax loophole has been closed by the federal government, the strategy is still being used to avoid taxes in several states. As states begin to take notice of corporations that avoid millions of dollars in taxes, some have employed various methods of recovering the tax funds and have taken steps to prevent corporations from avoiding taxes in the future. However, not all states have enacted effective means of closing this loophole. This summary analyzes the method of using “captive REITs” to avoid state tax liability, outlines the development of REITs, describes states’ efforts in recovering and preventing the use of REIT deductions, and advocates closing the loophole through legislation.

II. LEGAL BACKGROUND

To understand the significance of state tax loopholes with regards to captive REITs and the importance of closing these loopholes, it is first necessary to understand the role that REITs play in the economy and the ways in which corporations utilize REITs to avoid state tax liability. This section will first discuss REITs generally, including the statutory requirements on the structure and operation of REITs. Next, this section will describe the history and development of the REIT. Finally, this section will explore the techniques used by captive REITs to avoid state tax liability.

A. REITs Generally

A REIT is a type of organization governed by the Internal Revenue Code (IRC).¹ “A REIT is a corporation, trust, or association, that operates like a mutual fund, except that REITs own real estate and mortgages, as opposed to stocks, bonds, and other securities.”² The REIT allows investors to

1. See I.R.C. §§ 856-860 (2006).

2. *Bridges v. Autozone Props., Inc.*, 900 So. 2d 784, 795 (La. 2005).

pool their resources to invest in diversified real estate ventures.³ Since many REIT shares are traded on the major security exchanges, REITs allow investors to invest in real estate through easily transferable shares.⁴

In order to qualify for tax benefits, the IRC requires that a REIT must meet specific structural requirements and pass several tests. First, the IRC requires that at least one trustee or director manage the REIT.⁵ Freely transferable shares must evidence beneficial ownership of the REIT.⁶ The REIT must be taxable as a domestic corporation and cannot be a financial institution or an insurance company.⁷ Finally, at least one hundred shareholders must hold the beneficial ownership of the REIT for at least 335 days out of a twelve month period.⁸

In addition to the structural requirements, REITs must comply with several tests relating to the sources of the REIT's income,⁹ the nature of the REIT's assets,¹⁰ and the method of distributing the REIT's dividends.¹¹ If a REIT meets the requirements and can comply with the tests, the trust may elect REIT status.¹²

REITs are subject to numerous requirements, but, if it meets the statutory requirements, a REIT qualifies for favorable tax treatment. In order to avoid double and triple taxation, the IRC allows a REIT to deduct from its income the dividends it distributes to its shareholders, and the REIT must distribute at least 95 percent of its ordinary net taxable income to its shareholders.¹³ The REIT must pay regular corporate tax on the income that it does not distribute to shareholders.¹⁴ For federal tax purposes, individual shareholders must treat REIT dividends as ordinary portfolio income.¹⁵ Corporate shareholders are not entitled to deduct REIT dividends.¹⁶ While the IRC does not allow corporations to use REIT dividends as a deduction for dividends received in calculating federal tax deductions, many states still grant these deductions.

3. GEORGE GLEASON BOGERT, GEORGE TAYLOR BOGERT & AMY MORRIS HESS, *THE LAW OF TRUSTS AND TRUSTEES* § 248 (3d ed. 2000).

4. *Id.*

5. *Id.* § 856(a)(1).

6. *Id.* § 856(a)(2).

7. *Id.* § 856(a)(3)-(4).

8. *Id.* § 856(a)(5), (b).

9. *Id.* § 856(c)(2)-(3).

10. *Id.* § 856(c)(4).

11. *Id.* § 856(c).

12. *Id.* § 856(c)(1).

13. WILLIAM A. KELLEY, JR., *REAL ESTATE INVESTMENT TRUSTS HANDBOOK* 91 (2d ed. 1998).

14. *Id.* See also I.R.C. § 857(b)(1).

15. Leslie H. Loffman & Sanford C. Presant, *Taxation of Real Estate Investment Trusts*, 693 PLI/CORP 85 (2006).

16. *Id.* See also I.R.C. § 857(c).

B. Development of REITs

REITs originated in Massachusetts in the mid-nineteenth century as business trusts.¹⁷ At the time, Massachusetts law prohibited corporations from dealing in real estate.¹⁸ Corporations began using common law business trusts to invest in real estate and circumvent this prohibition, which became known as Massachusetts Business Trusts.¹⁹ A Massachusetts Business Trust is defined as “an unincorporated business organization created by an instrument by which property is to be held and managed by trustees for the benefit and profit of such persons as may be or become the holders of transferable certificates evidencing the beneficial interests in the trust estate.”²⁰

With its ruling in *Morrissey v. Commissioner*, the United States Supreme Court made the Massachusetts Business Trust a much less attractive option.²¹ Prior to the *Morrissey* decision, business trusts were not taxed on income that was distributed to the beneficiaries.²² However, in *Morrissey*, the Commissioner of Internal Revenue assessed income tax on trustees of a business trust, reasoning that the trust was doing business in a corporate capacity and should be taxed as such.²³ The Court agreed with the Commissioner and held that the trustees of the business trust should be taxed as a corporation because the trust was created to carry on business activities.²⁴ Holding real estate in trust lost tax advantages with the ruling in *Morrissey* and became less popular until 1960.²⁵

In 1960, President Eisenhower signed into law the Real Estate Investment Trusts Act (“1960 Act”).²⁶ Congress designed the 1960 Act to extend favorable tax treatment to REITs.²⁷ Regulated investment companies had received favorable tax treatment in the past, and Congress designed the Act to give similar treatment to REITs.²⁸ Congress also desired to increase the available funds for real estate development.²⁹

17. *Bridges v. Autozone Props., Inc.*, 900 So. 2d 784, 795 (La. 2005).

18. Herbert B. Chermiside, Jr., Annotation, *Modern Status of Massachusetts or Business Trust*, 88 A.L.R.3d 704, § 2 (1978).

19. *Id.* See also *Bridges*, 900 So.2d at 795.

20. Chermiside, *supra* note 18, § 2.

21. 296 U.S. 344 (1935).

22. *KELLEY*, *supra* note 13, at 2.

23. *Morrissey*, 296 U.S. at 349.

24. *Id.* at 360.

25. *Bridges v. Autozone Props., Inc.*, 900 So. 2d 784, 795 (La. 2005).

26. Pub. L. No. 86-779, 74 Stat. 998 (codified as amended at I.R.C. §§ 856-859 (2006)).

27. *BOGERT*, *supra* note 3, § 248

28. *Id.* (“By federal statute the term ‘investment company’ is used to describe any kind of business organization engaged in selling shares in a trust or fund to investors, whether operating with or without a trust, and for federal purposes includes face-

This legislation was especially significant to small investors. Congress noted that giving favorable tax treatment to REITs was desirable because it would allow investors with limited resources to take advantage of some of the benefits of investing in real estate that would otherwise only be available to those with larger resources.³⁰ These benefits included “diversification of investment which can be secured through the pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.”³¹ REITs allowed small investors to obtain these benefits “without being exposed to the risks of an active real estate business.”³²

In creating the 1960 Act, Congress set up the strict structural and operational regulations for REITs in order to ensure that the investors would be protected against business risks and so that REITs would act as passive investment entities.³³ Under the 1960 Act, Congress intended for REITs to earn money by renting out space and/or collecting interest on mortgages.³⁴ Under the qualification regulations, REITs were prohibited from managing or operating the property, except through an independent contractor.³⁵ Because REITs were designed to be passive investment entities, Congress felt that it was appropriate not to tax REITs at the corporate level.³⁶ Instead, REITs were allowed to deduct the amount paid as dividends to its shareholders.³⁷

The Tax Reform Act of 1986 changed the role of REITs.³⁸ With the passage of the Tax Reform Act, REITs were given a more active role in the

amount certificate companies, unit investment trusts and management companies.”). See also 15 U.S.C. § 80a-4 (2006).

29. KELLEY, *supra* note 13, at 3.

30. Charles E. Wern, *The Stapled REIT on Ice: Congress’ 1998 Freeze on Stapled REITs*, 28 CAP. U. L. REV. 717, 719 (2000) (citing H.R. REP. NO. 86-2020, at 3 (1960)).

31. *Id.* at 719-20 (citing H.R. REP. NO. 86-2020, at 3-4 (1960)).

32. David M. Einhorn, *Unintended Advantage: Equity REITs vs. Taxable Real Estate Companies*, 51 TAX LAW. 203, 204 (1998).

33. *Id.* at 204. REITs were originally designed to act as passive investment entities and not engage in active business operations. *Id.* at 209-10. “Originally, a REIT was not permitted to manage or operate its properties or furnish or render services to its tenants other than through an independent contractor from whom the REIT did not derive or receive any income.” *Id.*

34. *Id.* at 210.

35. *Id.* at 210 n.38 (citing the Real Estate Investment Trust Act of 1960, Pub. L. No. 86-779, 74 Stat. 998).

36. *Id.* at 205 (citing H.R. REP. NO. 86-2020, at 4). Corporations are subject to “double taxation” – a situation where the income of the corporation is subject to taxation at the corporate level, and the income is once again subject to taxation once distributed as dividends to the shareholders. 14A WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 6939 (2007).

37. I.R.C. § 857(b)(2) (2006).

38. Einhorn, *supra* note 32, at 210.

management and operation of their properties.³⁹ With the loosening of the regulations on REITs and eliminating some of the tax benefits of holding real estate in a partnership, REITs gained popularity.⁴⁰ Not only were small investors taking advantage of the tax benefits of REITs, as originally envisioned by Congress, but sophisticated corporate investors also began to take advantage of these tax benefits.⁴¹ As will be discussed in the following section, corporations began using REITs as a means of avoiding tax liability at the corporate level.⁴²

C. Tax Loopholes Relating to Captive REITs

In recent years, large corporations have begun to use REITs to avoid state tax liability. Corporations can avoid state tax liability with the use of private or "captive REITs." A captive REIT is structured so that "the majority of the stock is owned by one or more shareholders who contribute the bulk of the equity to the REIT, and a small number of shares, with a relatively nominal value, is held by 99 other shareholders."⁴³

Large, multi-state retailers can use this form of REIT to avoid paying state taxes by paying rent to themselves.⁴⁴ This happens when the parent corporation sets up a captive REIT, which owns all of the real property of the corporation (such as the retail stores).⁴⁵ The corporation then sets up a subsidiary to be the primary shareholder of the REIT in a state such as Delaware or Nevada, which does not tax dividends.⁴⁶ The corporation pays rent to the REIT for the use of the retail stores.⁴⁷ The corporation is allowed to deduct these expenses off its state income tax, as business expenses.⁴⁸ The REIT

39. *Id.*

40. In 1971, there were 34 REITs with market capitalization of approximately 1.5 billion dollars. National Association of Real Estate Investment Trusts, <http://www.nareit.com/newsroom/evolution.pdf> (last visited April 1, 2007). In 1986, there were 96 REITs with market capitalization of almost 10 billion dollars. *Id.* In 2005, there were 197 REITs with market capitalization of over 330 billion dollars. *Id.* Market capitalization is defined as the price of shares multiplied by the number of shares outstanding. *Id.*

41. *BankBoston Corp. v. Comm'r of Revenue*, 861 N.E.2d 450, 451 (Mass. App. Ct. 2007), *review denied*, 865 N.E.2d 1140 (Mass. 2007).

42. *Id.*

43. PETER M. FASS, MICHAEL E. SHAFF & DONALD B. ZIEF, *REAL ESTATE INVESTMENT TRUSTS HANDBOOK* § 5:122 (2006).

44. See Jesse Drucker, *Wal-Mart Cuts Taxes by Paying Rent to Itself*, WALL ST. J., Feb. 1, 2007, at A1, available at <http://www.realestatejournal.com/reits/20070205-drucker.html>.

45. MD. DEP'T OF LEGIS. SERVS., FISCAL & POLICY NOTE 3 (2007), available at http://mgadls.state.md.us/2007RS/fnotes/bil_0005/sb0945.pdf.

46. *Id.*

47. *Id.*

48. *See id.*

then pays this income to the subsidiary as dividends and is entitled to a deduction for dividends paid.⁴⁹ Those dividends are taxable as corporate dividends by the state of the shareholder's domicile.⁵⁰ The subsidiary avoids state tax liability because it is located in Delaware or Nevada where that type of income is not taxed.⁵¹ The income is eventually distributed back to the parent corporation, which does not pay state taxes on the income because it is entitled to deduct it as dividends received from a subsidiary.⁵²

This tax loophole is not only available to multi-state retailers, but it can also be utilized by multi-state banks. A bank can create a REIT mortgage or mortgage-backed securities originated by the bank.⁵³ The income from the interest is earned by the REIT, which then deducts it from their state income tax by paying it as dividends to another subsidiary, not subject to state taxes.⁵⁴ The mortgage interest income is funneled back to the parent corporation in the same way that the rent income is funneled.⁵⁵

However, federal tax laws do not allow such a deduction for captive REITs.⁵⁶ Congress closed this loophole by specifically restricting corporations from taking a deduction for dividends received from REIT distributions.⁵⁷ Despite this, according to a recent Wall Street Journal article, as of February 2007, twenty-five states have yet to close the loophole and still allow corporations to deduct dividends received by captive REITs.⁵⁸

III. RECENT DEVELOPMENTS

Captive REITs have become the subject of much attention, legislation, and litigation in recent years. States have taken several different approaches in their attempts to plug this perceived loophole. This section will address the two options that states appear to have in addressing this loophole. First, this section will discuss how some states have chosen to recover tax money that

49. *Id.*

50. KELLEY, *supra* note 13, at 136.

51. Drucker, *supra* note 44.

52. MD. DEP'T OF LEGIS. SERVS., *supra* note 45, at 3.

53. *Id.*

54. *Id.*

55. *Id.*

56. *BankBoston Corp. v. Comm'r of Revenue*, 861 N.E.2d 450, 451 (Mass. App. Ct. 2007), *review denied*, 865 N.E.2d 1140 (Mass. 2007).

57. I.R.C. § 243(d)(3) (2006) ("Any dividend received from a real estate investment trust . . . shall not be treated as a dividend."); I.R.C. § 857(c)(1) ("For purposes of section 243 (relating to deductions for dividends received by corporations), a dividend received from a real estate investment trust which meets the requirements of this part shall not be considered a dividend."). The loophole was closed by the Real Estate Investment Trust Act of 1960, the same legislation that created REITs. *BankBoston Corp.*, 861 N.E.2d at 452 n.3.

58. Drucker, *supra* note 44.

was deducted using captive REIT strategies through litigation. Then, this section will look at legislation that has been proposed or recently adopted by states to close the captive REIT tax loophole by disallowing corporations from taking a deduction for dividends received from a REIT.

A. States' Attempts to Recover Taxes through Litigation

Several states, including North Carolina, Massachusetts, and Louisiana, have opted to collect back taxes and penalties from corporations through litigation. These states have argued that various corporations wrongfully claimed a deduction for dividends received from a captive REIT.⁵⁹ However, states have not always been successful recovering back taxes and penalties through the courts.⁶⁰ Furthermore, recovering back taxes and penalties through litigation costs the states a great deal of time and resources.⁶¹

For instance, North Carolina challenged Wal-Mart's use of the captive REIT tax strategy when it charged the company with thirty-three million dollars in unpaid back taxes, interest, and penalties.⁶² In 2005, the state filed a lawsuit in the Superior Court in Raleigh, North Carolina, and the court ordered Wal-Mart to pay the back taxes, interest, and penalties.⁶³ Although Wal-Mart paid the amount, it has since sued the state for a refund.⁶⁴ As of March 6, 2007, the litigation continued with the issue still left unresolved.⁶⁵

Massachusetts has also instigated litigation to recover taxes it believed the State was owed due to inappropriately deducted dividends in a captive REIT scheme. Massachusetts' Commissioner of Revenue assessed a corporate excise tax on BankBoston for the years 1996 and 1997.⁶⁶ BankBoston utilized a REIT strategy where Matthews Street Real Estate Investment Trust, Inc. distributed over \$124 million in 1996 and 1997 to its corporate parent, Multibank Leasing Corporation (MLC), which was a wholly-owned subsidiary of the bank.⁶⁷ The REIT utilized the dividends-paid deduction to deduct the amount distributed to MLC, while MLC utilized the dividends-received deduction to deduct the amount it received from the REIT.⁶⁸ The court enunciated the quandary faced by the Commissioner: "If a recipient corporation

59. *See id.*

60. *Id.*

61. N.C. Justice Ctr., *It's Time to Level the Playing Field*, N.C. POL'Y BRIEF, Mar. 13, 2007, at 2.

62. Drucker, *supra* note 44.

63. *Id.*

64. *Id.*

65. *Maryland Plans New Look at Corporate Taxes*, AFX NEWS LIMITED, Mar. 6, 2007.

66. *BankBoston Corp. v. Comm'r of Revenue*, 861 N.E.2d 450, 450 (Mass. App. Ct. 2007), *review denied*, 865 N.E.2d 1140 (Mass. 2007).

67. *Id.* at 452 n.1.

68. *Id.* at 451.

may invoke the usual dividends-received deduction for earnings paid to it by a REIT subsidiary, then the earnings would entirely escape taxation at the corporate level, because the REIT has already claimed the dividends-paid deduction on the same earnings.”⁶⁹ The court realized the magnitude of the tax loophole at issue.⁷⁰

The court held in favor of the Commissioner, noting the importance of having consistency in Massachusetts’ definition of “dividend” with the federal definition of “dividend.”⁷¹ Massachusetts’ General Laws, c. 62 defines “dividend” as “any item of federal gross income which is treated as a dividend under the provisions of the [Internal Revenue] Code.”⁷² The court also pointed out the fact that Congress had closed the captive REIT loophole with language specifying that a dividend received by a corporate shareholder from a REIT was not considered a “dividend.”⁷³ The court held that the dividends received by the corporate shareholder could not be deducted for two reasons. First, the court identified that a dividend received by a corporate shareholder from a REIT was not treated as a “dividend” for federal income tax purposes. Second, the court emphasized the importance of uniformity between Massachusetts and federal tax law.⁷⁴ The holding in *BankBoston Corp.* illustrates one line of reasoning that can be used to recover back taxes through litigation.⁷⁵

The Louisiana Department of Revenue has also sought to collect 1,902,523 dollars in taxes, interest, and penalties that it claims Autozone Properties, Inc. improperly deducted using a captive REIT strategy.⁷⁶ Autozone employed a strategy where, through corporate restructuring, it created three subsidiary entities: Autozone Stores, Inc. (“Stores,” engaged in retail sale), Autozone Development Corp. (“Development,” the REIT), and Autozone Properties, Inc. (“Properties,” the primary shareholder of the REIT).⁷⁷

69. *Id.*

70. *Id.*

71. *Id.* at 453.

72. MASS. GEN. LAWS ch. 62, § 1(e) (2006).

73. *BankBoston Corp.*, 861 N.E.2d at 451. See also I.R.C. § 857(c) (2006) (“For purposes of section 243 (relating to deductions for dividends received by corporations), a dividend received from a real estate investment trust . . . shall not be considered a dividend.”); I.R.C. § 243(d)(3) (“For purposes of subsection (a) [which establishes the general dividends-received deduction] [a]ny dividend received from a real estate investment trust . . . shall not be treated as a dividend.”).

74. *BankBoston Corp.*, 861 N.E.2d at 457. Massachusetts has also sought to recover forty-two million dollars in back taxes, interest, and penalties from Fleet Funding, which the state claims was incorrectly deducted under a similar REIT strategy. Drucker, *supra* note 44.

75. *BankBoston Corp.*, 861 N.E.2d at 457.

76. *Bridges v. Autozone Props., Inc.*, 900 So. 2d 784, 788 (La. 2005).

77. *Id.* at 787.

All three entities were domiciled in Nevada.⁷⁸ Stores and Development were registered with the Louisiana Secretary of State and filed income tax returns with Louisiana, however Properties was not registered and filed no income tax return with the state of Louisiana.⁷⁹ Stores paid rent to Development in the amount of twenty million dollars between 1996 and 1998, which it deducted from its Louisiana income tax as rents paid.⁸⁰ Development distributed one hundred percent of its earnings to Properties as dividends, which it deducted as dividends paid.⁸¹ Thus, Properties received this income without paying any Louisiana income taxes.⁸²

The Department of Revenue did not contest Development's ability to utilize the dividends-paid deduction for the amounts distributed to Properties, as was the position taken by the Commissioner in *BankBoston Corp. v. Commissioner of Revenue*.⁸³ Instead, the Department asserted that Properties was required to pay income taxes on the amount received as rental income from rental property sourced in Louisiana.⁸⁴

The disputed issue in the case became whether Louisiana had jurisdiction over Properties in order to collect taxes on the distributions from the REIT.⁸⁵ The trial court concluded that Louisiana lacked jurisdiction because there were not sufficient "minimum contacts" to bring Properties under Louisiana's taxing authority.⁸⁶ The Louisiana Supreme Court disagreed, however, and reversed and remanded the case,⁸⁷ highlighting the constraints that the U.S. Constitution places on states' taxing authority.⁸⁸ The state supreme court found that Louisiana had jurisdiction, reasoning that "a state may tax a nonresident shareholder's investment income based on its investment in a separate corporation engaging in business activities in the taxing state, when the state has provided benefits, opportunities, and protections which contributed to the profitability of the in-state activities."⁸⁹ Because the court found that the state of Louisiana had provided these benefits, the court held that the

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.* See also *BankBoston Corp. v. Comm'r of Revenue*, 861 N.E.2d 450 (Mass. App. Ct. 2007), review denied, 865 N.E.2d 1140 (Mass. 2007).

84. *Bridges*, 900 So. 2d at 787.

85. *Id.* at 788.

86. *Id.* at 789.

87. *Id.* at 809.

88. *Id.* at 800-01 ("The Due Process Clause requires some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax, and the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State.")

89. *Id.* at 809.

state should be permitted to assess income taxes on the gains earned by Properties.⁹⁰

While the Supreme Court of Louisiana did not reach the issue of whether Properties was liable for the back taxes, the court set the stage to allow the state to recover taxes avoided through captive REIT schemes.⁹¹ The court arrived at its conclusion based on its interpretation of the Due Process Clause and its analysis of several United States Supreme Court decisions.⁹² Since the Due Process Clause and the United States Supreme Court cases would be binding on any other state, this decision could be an indication of how other states would decide the same issue.

This line of cases illustrates one option that states have to stop corporate shareholders from avoiding state tax liability through captive REIT schemes. While these states have achieved some favorable rulings in courts, it is often a time consuming process. Because litigation is uncertain and costly, some state legislatures have proposed and recently adopted legislation that prohibits corporate shareholders from utilizing a dividends-received deduction for REIT dividends.

B. Proposed and Recently Adopted Legislation to Close the Captive REIT Loophole

Although states have tried several approaches, closing the captive REIT loophole has not been as simple for the states as it was for the federal government.⁹³ While the federal government closed the loophole by disallowing corporate shareholders from deducting dividends received from a REIT, these corporate subsidiaries are often domiciled in states such as Delaware and Nevada, which do not tax this type of income. Thus, states must face the added burdens of jurisdictional issues that do not apply in the context of federal taxation.⁹⁴

North Carolina, for example, addressed this problem by bringing those corporate shareholders within their taxing jurisdiction through statute. In 2003, North Carolina adopted legislation that specified that rents attributable to property located in North Carolina were taxable by North Carolina.⁹⁵ The North Carolina legislature made this change in order to bring corporate REIT shareholders under the tax jurisdiction of North Carolina and to prevent those

90. *Id.*

91. *Id.*

92. *Id.* at 800-01. Specifically, the court referred to *International Shoe Co. v. State of Washington*, 326 U.S. 310 (1945), and *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

93. See *supra* Part II.C (discussing I.R.C. § 243(d)(3) and § 857(c)(1) which disallow a corporate shareholder from deducting dividends received from a REIT).

94. See, e.g., *Bridges*, 900 So. 2d at 788.

95. N.C. GEN. STAT. § 105-130.4(c), (d)(1) (2006) ("Net rents and royalties from real property located in this State are allocable to this State.").

corporate shareholders from avoiding state tax liability on captive REIT dividends.⁹⁶ This legislation has allowed North Carolina to avoid some of the jurisdictional problems that other states have faced, such as Louisiana in *Bridges v. Autozone Properties, Inc.*⁹⁷

Another option that states have in eliminating the captive REIT loophole is to adopt legislation that disallows a REIT from deducting rent payments received as a dividend paid. Maryland's General Assembly recently passed such a bill to close the captive REIT loopholes.⁹⁸ Senate Bill 945, later passed and codified as section 10-306.2 of Maryland's Code, closed the captive REIT tax loophole by disallowing captive REITs from utilizing the dividends paid deduction for state income tax purposes.⁹⁹ The bill's effect was limited to "captive REITs," and specifically did not apply to traditional REITs.¹⁰⁰

For instance, Maryland considered a bill in 2005 to close the captive REIT loophole; however, the bill was unsuccessful.¹⁰¹ When the tax strategies of corporations involving captive REITs recently began to receive more attention, Maryland Comptroller Peter Franchot announced that payments to captive REITs would no longer be deductible from corporate taxes.¹⁰² The Comptroller planned to disallow the tax deduction through corporate audits.¹⁰³

The state claimed that its authority to assess additional taxes came from section 10-109 and 10-306.1 of Maryland's Code.¹⁰⁴ Section 10-109 allows the Comptroller to reallocate income and deductions between related corporations and organizations to prevent tax-avoiding income shifting, if it is necessary "in order to reflect an arm's length standard."¹⁰⁵ Section 10-306.1 re-

96. N.C. DEP'T OF REVENUE, NORTH CAROLINA 2003 TAX LAW CHANGES 10, available at http://www.dornmc.com/practitioner/Law_Changes_2003.pdf.

97. See *Bridges*, 900 So. 2d at 788.

98. S. 945, 422d Sess. (Md. 2007). See also MD. CODE ANN., TAX-GEN. § 10-306.2 (West 2007).

99. MD. DEP'T OF LEGIS. SERVS., *supra* note 45, at 1.

100. S. 945, 422d Sess. (Md. 2007) (defining a "Captive REIT" as a REIT under the Internal Revenue Code that is "not regularly traded on an established securities market" and that has "more than 50% of the voting power or value of the beneficial interests or shares of which, at any time during the last half of the taxable year, is owned or controlled, directly or indirectly, by a single entity that is subject to the provisions of Subchapter C of Chapter 1 of the Internal Revenue Code").

101. House Bill 1581 was introduced during the 2005 session by Del. Sheila E. Hixson. H.R. 1581, 2005 Sess. (Md 2005), available at <http://mlis.state.md.us/2005rs/bills/hb/hb1581.pdf>.

102. Press Release, Comptroller of Maryland, Franchot Closes Corporate Tax Loophole: "Captive" Real Estate Deals Targeted (Mar. 6, 2007), available at <http://www.marylandtaxes.com/publications/nr/current/pr09.asp>.

103. MD. DEP'T OF LEGIS. SERVS., *supra* note 45, at 4.

104. *Id.*

105. *Id.* at 5.

quires corporations to report income that was deducted as an expense paid “directly or indirectly to one or more related members, unless certain conditions are met, including that the transaction did not have as a principal purpose the avoidance of tax.”¹⁰⁶ The Fiscal and Policy Note for Senate Bill 945 noted that the state could become involved in lengthy litigation in recovering taxes avoided through captive REIT strategies.¹⁰⁷ Senate Bill 945 expressly disallows the dividends paid deduction for captive REITs¹⁰⁸ and could prevent litigation on the issue in the future.

New York also took steps to eliminate the captive REIT tax deduction. In its 2007 budget, New York will phase out the deduction for dividends paid by captive REITs, over the course of four years.¹⁰⁹

These states have realized that litigation can be a time-consuming and uncertain process of attempting to recover back taxes that they believe were incorrectly deducted from corporate tax returns, especially when existing statutes appear to be silent on to the appropriateness of dividends paid deductions for captive REITs. By passing specific legislation that expressly forbids this practice, states can clarify the tax law and possibly avoid lengthy litigation in the future.

IV. DISCUSSION

Large multi-state corporations have used the captive REIT strategy to avoid millions of dollars in state taxes. State legislatures ought to enact legislation to prevent corporations from avoiding their share of tax liability through captive REIT strategies. In order to help solve some of the budget problems faced by states, state legislators should follow the federal government’s lead and close captive REIT tax loopholes. Legislation is necessary to address this issue for three reasons. First, these corporations are allowed to utilize state resources to earn their profits, yet pay only a fraction of their tax liability by essentially paying themselves “rent.” The tax liability is then shifted to other tax payers and contributes to budget deficits. Second, captive REITs that take advantage of dividends-paid deductions are using an investment tool in a way that it was not intended to be used. This is beyond the original purpose of REITs, which is apparent from the fact that the federal government does not allow a tax deduction for captive REITs. Finally, legislation is necessary to close this loophole because litigation is an uncertain and time-consuming process to challenge this tax strategy.

106. *Id.*

107. *Id.* at 4.

108. *Id.* at 2.

109. Robert Ward, New Budget Includes Major Tax Reductions for Manufacturers, Other Business (Apr. 2, 2007), <http://www.bcnys.org/whatsnew/2007/0402budget.htm>. Governor Eliot Spitzer estimated that the loophole was costing New York eighty-three million dollars per year. Drucker, *supra* note 44.

The first reason states need to adopt legislation to close captive REIT loopholes is that millions of dollars of state tax burden is being shifted from corporations to others, including working families. While large, multi-state retailers reap the financial rewards of sophisticated tax strategists, states' health and education programs pay the price. State budgets cannot afford to forego hundreds of millions of dollars every year because of captive REIT systems, and legislation is necessary to reclaim these lost tax dollars.

In recent years, many states have faced budget problems. In 2003, 37 states were forced to make mid-year budget cuts.¹¹⁰ While states have, overall, recovered from what has been called the "fiscal crisis" of 2002 and 2003, Medicaid costs and under-funded employee pension plans remain a pressure on state budgets.¹¹¹

Despite the pressures on state budgets, the percentage that corporations pay in state and local income tax has declined. The average percentage that corporations pay in state and local tax went from 6.7 percent in the 1980s to around five percent during recent years.¹¹² One study looked at the state and local income tax payments of 252 Fortune 500 companies, and found that, in 2003, these companies paid an average of 2.3 percent of the U.S. profits in state and local income tax.¹¹³ This is despite the fact that the average state statutory corporate tax rate was 6.8%.¹¹⁴ During 2001-2003, the study found that these 252 companies avoided 41.7 billion dollars in state corporate income tax.¹¹⁵

Wal-Mart has recently drawn much attention for its use of captive REIT strategies. A recent Wall Street Journal article estimated that, between 1998 and 2001, Wal-Mart and Sam's Club saved an estimate 350 million dollars in state corporate income tax by making rent payments to its own REITs.¹¹⁶ According to a study by the Citizens for Tax Justice, between 1999 and 2005, while Wal-Mart reported 77.4 billion dollars in pre-tax profits to their shareholders, they managed to pay only 2.4 billion dollars in state income taxes, a rate of just over three percent.¹¹⁷ The Citizens for Tax Justice estimated that Wal-Mart avoided approximately 2.3 billion dollars in state income taxes

110. NAT'L GOVERNORS ASS'N & NAT'L ASS'N OF STATE BUDGET OFFICERS, THE FISCAL SURVEY OF STATES 1 (2006), *available at* <http://www.nasbo.org/Publications/PDFs/> (follow "Fall 2006 Fiscal Survey of States_FINAL.pdf" hyperlink).

111. *Id.* at vii.

112. Drucker, *supra* note 44.

113. ROBERT S. MCINTYRE, CITIZENS FOR TAX JUSTICE, & T.D. COO NGUYEN, INST. ON TAXATION & ECON. POLICY, STATE CORPORATE INCOME TAXES 2001-2003 1 (2005), *available at* <http://www.ctj.org/pdf/corp0205an.pdf>.

114. *Id.* at 3.

115. *Id.* at 1.

116. Drucker, *supra* note 44.

117. *According to the Citizens for Tax Justice, New Research Shows Wal-Mart Rigs the System to Skip Out on \$2.3 Billion in State Taxes*, PR NEWSWIRE, Apr. 16, 2007.

during this period, part of which was attributable to its use of captive REITs.¹¹⁸

By using captive REIT structures, corporations are able to reap many benefits, with little of the cost. For example, Wal-Mart has been widely criticized for failing to provide health benefits to many of its employees.¹¹⁹ By avoiding state taxes through captive REIT programs, some believe that Wal-Mart further exasperates this problem by not contributing to the state health programs that its employees will ultimately depend on.¹²⁰ Corporations such as Wal-Mart are able to circulate billions of dollars, while paying a fraction of their state income tax liability.¹²¹ As a result, state budgets and state citizens end up bearing the costs of these captive REIT structures.

Not only are captive REIT structures leading to an unequal distribution of tax burdens, but, the corporations using the captive REITs are using them in a way that was not originally intended. Because corporations are using REITs outside of its original purpose, state legislatures should pass legislation to prevent the abuse of a valid investment tool. Congress originally created REITs to allow investors, especially those with limited resources, to invest more easily in a wide range of real estate.¹²² REITs were designed to give small investors some of the benefits of investing in real estate, such as diversification of investments, without all of the business risks.¹²³ Congress gave REITs benefits through tax deductions, but specifically precluded captive REITs from taking the tax deductions.¹²⁴ This shows that Congress did not intend to give the same benefits to those REITs that are set up just for tax avoidance purposes.

Despite this fact, corporations continue to use captive REITs to take advantage of benefits intended for investors. Because many states' definitions of REITs are based on the federal definition of REITs, states have, in essence, adopted the federal government's formulation of REITs.¹²⁵ However, some states have failed to also adopt the provisions that preclude captive REITs from using dividends paid deductions.¹²⁶

Because states have followed the federal formulation of REITs, states should also take notice of the fact that the federal government precludes the

118. *Id.*

119. *Wal-Mart: Groups in Urban Areas Seek Improved Health Benefits*, AM. HEALTH LINE, Jan. 9, 2007.

120. AFL-CIO, *The Wal-Mart Tax: Shifting Health Care Costs to Taxpayers*, Mar. 2006, available at http://www.aflcio.org/corporatewatch/walmart/upload/walmartreport_031406.pdf.

121. Drucker, *supra* note 44.

122. *See supra* Part II.B.

123. *See supra* Part II.B.

124. *See supra* note 57 and accompanying text.

125. *See supra* notes 71-72 and accompanying text.

126. *See supra* notes 61-62 and accompanying text.

dividends-paid deduction for captive REITs.¹²⁷ Allowing corporations to use captive REIT structures to avoid state tax liability is not what Congress intended when it created REITs in 1960.¹²⁸ For this reason, states should end this abuse by passing legislation to preclude captive REITs from taking a dividends-paid deduction.

The final reason that legislation is necessary to close the captive REIT tax loophole is that legislation would reduce the need for lengthy and uncertain litigation to recover back taxes.¹²⁹ Litigation is a time consuming process. Even though some states have been successful at recovering taxes, the success comes at the cost of several years and multiple appeals.¹³⁰ Without a clear policy on captive REITs, the state must audit and target individual corporations to recover taxes.

Several states have turned to litigation to recover taxes that corporations have avoided through captive REIT structures, including North Carolina, Massachusetts, and Louisiana.¹³¹ Without specific legislation disallowing the dividends paid deduction for captive REITs, states have had to find their authority in other statutes already on the books, as Maryland's Comptroller did.¹³² States have also faced jurisdictional issues, before the court will even hear the merits of their cases, as was the situation faced by Louisiana in *Bridges v. Autozone Properties, Inc.*¹³³ Even if the state is able to achieve a favorable result, it can become tied up in a lengthy appeals process, as North Carolina faces with its suit against Wal-Mart.¹³⁴

State legislators can eliminate some of the hardships that the tax commissioners face when attempting to recover taxes avoided through a captive REIT structure. Passing specific legislation that expressly disallows the deduction would provide a definitive rule for corporations to follow. Presently, corporations defend their use of captive REIT structures as a legal tax strategy.¹³⁵ At the same time, state tax officials have challenged their use of captive REIT structures in courts. There seems to be an obvious disagreement between corporate tax strategists and state tax officials as to the legality of this type of tax structure. This disagreement has led to costly and time-consuming litigation. State legislatures ought to clear up the discrepancy by

127. *Id.*

128. See *supra* note 27-29 and accompanying text.

129. See *supra* note 61-62 and accompanying text.

130. See, e.g., *BankBoston Corp. v. Comm'r of Revenue*, 861 N.E.2d 450, 450 (Mass. App. Ct. 2007), *review denied*, 865 N.E.2d 1140 (Mass. 2007); *Bridges v. Autozone Props., Inc.*, 900 So. 2d 784, 809 (La. 2005).

131. See *supra* Part III.A.

132. See *supra* Part III.B.

133. 900 So. 2d 784. See also *supra* Part III.A.

134. See *supra* Part III.A.

135. See Drucker, *supra* note 44 (quoting Wal-Mart spokesperson John Simley, who stated that Wal-Mart "is comfortable with its current structure and is in compliance with federal and state tax laws").

passing specific legislation dealing with the deductibility of captive REIT payments.

Legislation is necessary to put an end to the captive REIT tax loophole. The loophole has led to an unfair shifting of the state tax burden, allowing corporations to profit while paying only a fraction of their tax liability. This type of tax avoidance strategy goes beyond the original intent of Congress in creating REITs, and the lack of legislation has led to costly and uncertain litigation to solve the issues relating to the deductibility of captive REIT payments. State legislatures should end the abuse and confusion and close the captive REIT loopholes.

V. CONCLUSION

While REITs were originally created and designed to give investors, especially those with limited resources, a powerful tool to invest in real estate, multi-state corporations have been exploiting REITs to avoid state tax liability. By shifting their income in the form of “rent” paid to themselves, they have managed to avoid hundreds of millions of dollars in state tax liability through captive REIT structures. States have attempted to solve this problem and recover taxes avoided by corporations utilizing captive REIT structures through litigation, however clear and specific legislation is necessary to close the loophole and end the unfair shifting of state tax burdens and the lengthy litigation that states have faced in recovering lost taxes.

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